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Seeking The Road To El Dorado

California Joan consults with the experts about the ethical perils of accepting stock in clients' companies

By ELLEN R. PECK

EDITOR'S NOTE: *This is part two of a two-part series. Part one, also eligible for one hour of MCLE credit in legal ethics, appeared in the December 2000 Bar Journal and also is available online in the December Bar Journal web version, www.calbar.org.*

California Joan, under an edict to report back to the Firm's management committee about compliance with ethical requirements in accepting stock in client companies in lieu of fees for legal services, felt as overwhelmed as the farmer's daughter ordered by her king to spin a room full of straw into gold by morning. (Folktale, Rumpelstiltskin.) Cali decided to consult Silicon Valley lawyers who popularized taking stock in their start-up company clients and attended a roundtable seminar involving some of the gurus of those law firms talking about these ethical issues.

PRACTICAL TIPS ON THE FIVE STEPS TO RULE 3-300 COMPLIANCE

"In complying with rule 3-300, Rules of Professional Conduct, how can we ensure that the acquisition of a client's stock in exchange for legal services is fair and reasonable to the client?" asked Panel Moderator.

"Much of the time, this is not a difficult issue. The value of the stock has already been set for 'founders' shares or for 'friends and family' shares or by the market.

"Therefore, the amount of stock ultimately transferred can be based upon these set values in exchange for like value of services at an hourly rate or fixed fee," said Genaro Counsel, the general counsel of Starte Upps, the renowned Silicon Valley law firm that had successfully started up more companies than Mrs. Fields has cookies and had profited from successful investments in their clients.

"If possible, I think the stock should be valued at the amount per share that cash investors, knowledgeable about its value, have agreed to pay for their stock about the same time," cautioned Elmer Ethics, Chair of the Euphoria City Bar Association Legal Ethics Committee.

Ivy Invest, partner of another well-known Silicon Valley law firm, Take It Public Inc., added: "The value of an agreed percentage of stock to be issued is not always reasonably ascertainable.

"Suppose, for example that a lawyer is engaged by two founders who are contributing intellectual property for their stock and they have not established the cash value of their contribution. In this case, it is likewise difficult to establish, with reasonable certainty, the value of the shares to be issued to the lawyer.

"Therefore, the percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, so that the legal services will contribute to the potential success of the enterprise." (American Bar Association Formal Ethics Opinion 00-418.)

"Well, I think that a lawyer in those or similar circumstances should seriously consider engaging an investment professional to advise as to the value of the securities. The client can then make its own in-formed decisions as to the reasonableness of the transaction," El-mer Ethics retorted. (Association of the Bar of the City of New York Com-mittee on Profes-sional and Judicial Ethics Formal Opn. 2000-3.)

Genaro added, "While that might be appropriate risk management, we don't want to set that as a standard since those expenses are often prohibitive for a start-up company or for small and solo law firms."

Darla Defender, a partner at a well-known legal malpractice defense law firm, focused upon vesting of the stock after the value was determined. "Vesting of the stock may create problems of fairness, if the stock vests to the lawyer or law firm before the services are completed.

"After you have created a stock for fees agreement that is fair and reasonable, step two involves documenting the terms of the transaction in writing, in terms which can be reasonably understood by the client."

"Most of the time, since you may be dealing with sophisticated people, that is not a problem. However, as a risk management issue, I try to use language in a document that could ultimately be understood by members of a jury," Genaro said.

Ivy added, "Yes, but mere transfer of the stock may be an insufficient writing. Try using a fee agreement or memorandum of understanding. Also, make sure that you have the terms of the transaction and the consent of the appropriate directors or officers recorded in the corporate minutes or other appropriate documents."

"Once you've completed the documentation of the terms of your stock acquisition, don't forget step three! You must advise the client, in writing, of the opportunity to seek independent counsel of the client's choice," reminded Darla Defender.

"Next, step four requires that you afford the client an opportunity to seek the advice of independent counsel on the transaction. While the amount of time varies with the immediacy of the client's need for legal services, the client must have some time to actually consult with counsel," claimed Elmer Ethics.

Ivy added her experience, "If the client elects to consult independent counsel, remember to document the name of the lawyer whom the client consulted. If the client does not consult other counsel, have the client acknowledge that they had an opportunity to consult counsel but declined to do so."

"The last step," concluded Genaro, "requires you to obtain the client's written consent to the terms of the transaction after compliance with the first four steps. If you have a client corporation, make sure the consent is recorded in the corporate minutes or that other corporate formalities are undertaken."

CHALLENGES TO THE DUTY TO EXERCISE INDEPENDENT JUDGMENT

"After compliance with rule 3-300, a lawyer must still determine whether this ownership interest in the client reasonably might affect the exercise of independent professional judgment on behalf of the client. What are the issues lawyers should consider?" asked Panel Moderator.

"I think that you have to analyze the representation against the acquisition," replied Genaro Counsel. "If there is merely a 'fanciful, theoretical or de minimus risk that the lawyer's judgment will be affected adversely by a potentially relevant set of interests,' the ethical duties should not be restrictive."

"Wait a minute . . ." interrupted Elmer Ethics, "the duty to exercise independent judgment on behalf of a client has long been understood to foreclose the lawyer from undertaking a representation, even with the client's consent after full disclosure, if there is a reasonable probability, based upon an objective standard, that the lawyer's interests will affect adversely the advice to be given or the services to be rendered to the client." (New York State Ethics Opinion No. 712 (1999).)

"I think there is some middle ground here," said Darla Defender. "Lawyer acceptance of securities as compensation for future legal services to a client company may affect the lawyer's professional judgment.

"For example when a lawyer accepts a client corporation's securities as a fee for negotiating and documenting an equity investment, or for representing it in connection with an initial public offering, there is a risk that the lawyer's judgment will be skewed in favor of the transaction to such an extent that the lawyer may fail to exercise independent professional judgment. But this possibility is fact driven and not inherent in every situation."

Elmer added, "It is also possible that the lawyer's interest may create economic pressure to 'get the deal done,' and that this pressure in turn may impact the lawyer's independent judgment on disclosure issues, creating liability for both client and lawyer."

Ivy Investment disagreed. "This risk is not really any different from when a lawyer's cash fee depends (in whole or in part) on a business transaction's successfully closing. In both cases, the lawyer is 'invested' in the transaction.

"Yet the contingent fee arrangement has long been accepted as ethical if the fee is appropriate and reasonable and the client has been fully informed as to alternative billing arrangements. (ABA 389 (1994).)

"There is really no ethical distinction between the transactional contingent fee and agreeing to take client securities instead of cash fees." (Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opn. 2000-3.)

Elmer was not to be put off. "Surely, the risk to a lawyer's independent judgment would be especially high when there is a potentially very large fee paid in client securities which represents both a significant portion of the law firm's revenues and a substantial stake in the client's business.

"The desire to obtain such a fee might diminish, inadvertently, the willingness of the attorney to advise the client company to disclose negative information or increase the lawyer's willingness to issue a questionable legal opinion required to close the deal.

"This would present a non-consentable actual conflict and the fee arrangement might be ethically prohibited." (Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opn. 2000-3.)

Genaro Counsel said, “To prevent this happening, our firm’s stake in its clients is limited to 1 percent or less and we try to limit our reliance on particularly big clients.”

Elmer added another example. “Compromising independent judgment can also occur when a lawyer’s compensation depends directly in whole or in part on the amount of fees generated for the firm and where the particular lawyer is also responsible for providing the legal services involved.”

“To minimize these kinds of risks, our firm does not allow individual lawyer investments in the clients for which the lawyer provides services,”countered Genaro.

Ivy added, “Our firm allows individual lawyer investment. But as a risk management issue, we either prohibit an attorney from working on matters of a client that he or she brought into the firm and that is that is paying its fees through securities or place some other partner in charge of the matters.” (Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opn. 2000-3, fn. 12.)

Elmer added, “In evaluating the potential for erosion of the independence of judgment, lawyers should consider factors such as ‘the size of the investment in proportion to the holdings of other investors, the potential value of the investment in relation to the law firm’s earnings or assets, the possible impact on the lawyer of levels of risk involved, and whether the investment is active or passive.’” (Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opn. 2000-3; see also “Investing in Your Client’s Business,” Wash. State Bar News (March 2000).)

Darla Defender added the final word. “However, even if not ethically mandated, if there is the potential for exposure to charges of diminution of exercise of independent judgment. As a matter of risk management, make a full disclosure in writing of the relevant circumstances and the reasonably foreseeable adverse consequences to the client and obtain the client’s written consent to continued representation.”

ILLEGAL OR UNCONSCIONABLE FEES

Panel Moderator introduced a new topic. “In California, a lawyer can not enter into an agreement for, charge or collect an illegal or unconscionable fee. What steps do lawyers need to take to ensure that they do not run afoul of these prohibitions set forth in rule 4-200, Rules of Professional Conduct?”

Darla responded first. “Unconscionability is determined by the factors enumerated by rule 4- 200(B). Therefore, any fee including stock should be evaluated according to those factors to make sure the fee is not unconscionable.”

Elmer Ethics chimed in again. “But securities received for legal services is a more complex question. Lawyers should consider additional factors, especially when stock relates to ‘start up’ businesses or is part of a public offering of securities.

“The Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opn. 2000-3 listed some of these additional considerations:

"(1) the likelihood the transaction in question will or will not close and whether there are any contingent plans for payment of legal fees; (2) the estimated current and future value of the equity [i.e., securities] interest considering all the normal risks of a start-up business and any specific risks to the business or its assets; (3) the liquidity of the interest, including whether it is now or may in the future be publicly traded; (4) any restrictions on transfer of the interest, whether by agreement with the client . . . or by law; (5) the percentage amount of the interest, and what, if any, degree of control it provides the lawyer over the business; and (6) what restrictions, if any, are placed on the money used to pay for the equity interest — for example that it must be used to pay future legal bills."

Genaro Counsel raised another point. "Some ethics committees in other states have opined that a contingent fee is created where securities are given as an attorney's fee in payment for legal services furnished in a public offering. (See Kansas Bar Association, Ethics Opinion 98-6 (Sept. 25, 1998); Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opn. 2000-3.)

"The difficulty in estimating the value of the securities or the size of the fee until the success or failure of the matter or transaction has been established creates elements of contingency. Moreover, the failure of the offering will likely lead to no securities being given, or whatever is given being worthless, creating further analogies to a contingency fee.

"Therefore, lawyers' fee agreements in these type of circumstances should include the statutory requirements for a contingency agreement." (See Business & Professions Code §6147.)

Ivy Invest added another wrinkle. "Especially with securities in a startup company, the fair market value of the stock cannot be determined with any degree of assurance, until the transaction or matter is completed. If an equity stake in a corporation turns out to be successful, the value of the stock at a high point might seem unconscionable in relation to the services rendered if the value is determined only with the wisdom of hindsight."

Genaro added, "To make this evaluation after a success is completely unfair. It overlooks the value of the fee that the client agreed to pay or the lawyer accepted, because it eliminates the risk that the lawyer undertook that the venture would fail and the securities would have little or no value!"

"Yes, for every one big success, there are only a few investments where the law firm breaks even and some start-up clients' stock becomes worthless," added Ivy.

"That is why recent ethics committees have opined that whether the fee violates ethical limits on fees must be determined at the time that the transaction was entered into, giving value to the lawyer's risk." (See American Bar Association Formal Ethics Opinion 00-418, Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opinion 2000-3, District of Columbia Bar Association Legal Ethics Committee Opinion No. 300.)

Darla Defender added one issue: "When the applicable corporate law prohibits a corporation from paying fees for future professional services, a lawyer should ensure that the stock does not vest until after the completion of the legal services to prevent the collection of an 'illegal fee' prohibited by rule 4-200(A)."

WITHDRAWAL OR DISCHARGE

Panel Moderator asked, “Darla, what should a lawyer or law firm do when they have accepted securities in whole or in part as a substitute for cash fees and they are discharged by the client or withdraw before finishing the contemplated legal services?”

“Rule 3-700(D)(2), Rules of Professional Conduct require a lawyer to refund any part of a fee paid in advance that has not been earned,” answered Darla. “If work has not been completed, unearned portions of the stock must be credited or refunded to the client.”

CONCLUSION

Leaving the seminar, Cali resolved to consult with the participants to tailor a risk management program that was appropriate to her firm’s individual clients and her firm’s desired investments and covered other practical legal compliance issues. Most of all, Genaro Counsel’s closing words rang in her ears: “Don’t get greedy, don’t think you are going to get rich from any single client’s stock, and be careful out there!”

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Test —Legal Ethics
1 Hour MCLE Credit

This test will earn 1 hour of MCLE credit in Legal Ethics.

1. True/False. A lawyer's acquisition of a client's stock in exchange for legal services should be fair and reasonable to the client.

2. True/False. Valuation of stock should be set by some objective measurement such as the price set for founders shares, or 'friends and family' shares or by the market.

3. True/False. Another method of valuation is to value the stock at the amount per share that cash investors, knowledgeable about its value, have agreed to pay for their stock about the same time.

4. True/False. Since the value of stock to be issued is always reasonably ascertainable, the lawyer can easily set the price of the stock to be exchanged for legal services.

5. True/False. The percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer, at the time of the transaction.

6. True/False. When the value of the stock is not reasonably ascertainable, a lawyer is required to engage an investment professional to advise the client regarding the value of the securities.

7. True/False. Vesting of the stock is never a consideration in determining fairness and reasonableness.

8. True/False. Since all the principles of start-up companies are sophisticated, no writing other than the transfer of stock is necessary to comply with the writing requirement of rule 3-300.

9. True/False. Another means of compliance with the writing requirement of rule 3-300 is to have the terms of the transaction and the consent of the appropriate directors or officers recorded in the corporate minutes.

10. True/False. The client must be advised in writing of the opportunity to seek independent counsel of the client's choice, even though the client is sophisticated.

11. True/False. The written advisement to seek independent counsel is only a formality for the sophisticated client; the sophisticated client need not be afforded an opportunity to seek the advice of independent counsel on the transaction.

12. True/False. It is not necessary to document which independent counsel the client consulted.

13. True/False. It is also good risk management to document the client's acknowledgement that the client did not desire to seek independent counsel after being advised in writing to do so and after having been afforded an opportunity to do so.

14. True/False. After full compliance with the first four steps, the client's written consent to the terms of the transaction is really unnecessary.

15. True/False. A lawyer must determine whether an ownership interest in the client reasonably might affect the exercise of independent professional judgment on behalf of the client.

16. True/False. Where it is possible that the lawyer's interest may create economic pressure to 'get the deal done,' and that this pressure in turn may impact the lawyer's independent judgment on disclosure issues, the lawyer should orally explain the conflict to the client.

17. True/False. One practical method of lessening the diminution of a lawyer's independent judgment is to limit the firm's stake in its clients to 1 percent or less.

18. True/False. Preserving independence of judgment in taking equity in client companies involves lawyer consideration of the size of the investment in proportion to the holdings of other investors, the potential value of the investment in relation to the law firm's earnings or assets, the possible impact on the lawyer of levels of risk involved, and whether the investment is active or passive.

19. True/False. In ensuring that taking stock in client companies in lieu of legal fees does not violate the prohibition against unconscionable fees, a lawyer must consider the estimated current and future value of the equity [i.e., securities] interest considering all the normal risks of a start-up business and any specific risks to the business or its assets.

20. True/False. The value of the lawyer's interest in client stock will be determined at the time the client makes a claim of misconduct against the lawyer.

Certification

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